

CHAPTER 3

ASIA'S BOOM AND BUST

Introduction. Asia's economic roller coaster shows no signs of stopping. In the past five years, an Asian economic miracle has given way to:

- Economic crisis in 1997
- Recession in 1998
- Bounce-back in 1999/2000
- Downturn/Recession in 2001

Downward Drivers. The economic drivers that lifted these economies out of recession in 1999 are losing their punch. At a minimum, a variety of factors have slowed down growth in 2000. These negative factors include:

- Weaker U.S. economic growth
- As U.S. high tech demand falters, the U.S. economy slows down, which in turn reduces the U.S. appetite for Asian exports.
- Political instability in the region (scaring off investors)
- A spike up in oil prices

Financial Instability. In addition, the day of reckoning for incomplete corporate and financial reforms is here.

- Asian stock markets and foreign exchange rates have already plummeted.
- This slowdown could easily deteriorate into an even worse boom and bust scenario unless Asian leaders get more serious about reform.
- Asian states need to make their economies less vulnerable to evidence of rising financial turbulence in Asia and the rest of the world.

Key Questions: What other stresses could derail things? And what policy actions could minimize the risks and make these economies less vulnerable to financial turbulence?

Rising Deficit Spending. Before answering these questions, let's first ask, Which factors have been driving this bounce-back? And are these economic drivers sustainable?

- For starters, a Keynesian surge in government deficit spending helped to

drive domestic demand and lift the crisis-hit economies out of recession.

- Countries that consistently ran budget surpluses ran large budget deficits.
- For instance, among the nine major Asian developing economies, only Singapore is still running a budget surplus.

Emerging Problems. It's now clear that the recovery in 1999 had a strongly cyclical tinge to it.

- Non-sustainable economic drivers—such as deficit spending and buoyant demand in the United States for Asia's technology exports—drove Asian growth.
- While the Asian region is still recovering, progress on economic reforms has been spotty at best.
- Momentum is slowing down in corporate and banking restructuring.
- Institutional structures fully supportive of sustainable growth don't exist yet.
- While bankruptcy laws are now in place in many of the economies, enforcement is still a major issue.

Falling Foreign Direct Investment (FDI). These structural reform shortfalls continue to worry investors, who in turn are reducing FDI in many Asian economies.

- Investor exuberance about Asia as a whole has given way to a new realism.
- In particular, investors started making distinctions about Asian economic leaders and Asian economic laggards.

China Up, ASEAN Down. While it's always difficult to generalize, the laggards began to cluster inside ASEAN.

- This past year, ASEAN economies received just 17% of the FDI that flowed to developing countries in Asia, down from around 61% in the early 1990s.
- In contrast, China, which got just 18% of the FDI coming to developing Asian economies a decade ago, received 61%.
- In short, the tables have turned.
- ASEAN economies are starting to lose "head to head" competition with China to attract FDI.

ASEAN Protectionism. Why is this happening? At a time of when ASEAN should be making every effort to move toward trade liberalization, ASEAN states are moving toward more protectionism.

- At the ASEAN meeting in Chiang Mai in September 2000, ASEAN states agreed to allow countries to delay honoring their tariff reduction commitments.
- Malaysia is already going down this protectionist path.
- Malaysia announced earlier in 2000 that it would not meet its obligations to lower tariffs on automobiles imported from Southeast Asian countries
- Why? It's afraid that its national car, the Proton, would be unable to compete with a flood of imports.
- Potential investors fear that now Malaysia has set a precedent.
- Other ASEAN countries will request delays in lowering tariffs as well.

External Oil Shock. Another serious blow for many Asian economies was the surging price of oil, which hit a 10-year high of over \$34 a barrel early in the millennium (although it fell to \$18 during the 2001 recession and then rose to \$23 a barrel in February 2002).

- No other region of the world is as vulnerable to soaring oil prices as Asia.
- Why? Asia relies more heavily on energy-consuming manufacturing for its growth than the West.
- The energy price hike forced oil-consuming Asian states to boost energy spending at the expense of investment.
- The net effect is a long term-drag on Asian productivity.
- Oil spike up also eats away at consumer spending power.
- Depressed consumer spending could dampen corporate earnings.
- The worry is that falling corporate earnings could eventually take almost 2% off overall profit growth in 2001.

U.S. Slowdown. As external demand in the United States slows down, Asian companies that can now barely pay down their high debts are quickly going under.

- The electronics sector—a key economic driver in places like Taiwan—is a potential example of a mini-cycle downturn in growth.
- Computer chipmakers and other technology stocks have been battered in recent months over fears that the global electronics boom may be peaking.
- Besides fanning global financial turmoil, this trend is prompting Asian states to cut social spending, thus worsening the plight of Asia's poor.
- That worsens ethnic conflict, as it did in Indonesia after the outbreak of the Asian economic crisis.

Falling Asian Stocks. In addition, stock markets in much of Asia have been falling.

- Stock market declines have been especially pronounced in South Korea, Indonesia, Thailand, Taiwan and Japan.
- The worst hit stock markets, such as Thailand and the Philippines, have hit lows similar to those experienced during the worst phases of the Asian economic crisis.

What's wrong? Asia's dependence on high-tech is causing problems as high tech demand weakens around the world.

- Falling demand for dynamic random access memory (DRAM) chips have caused prices to plunge.
- This weak tech demand and troubled financial systems are the two key factors that have caused Asian stock markets to plunge in recent months.

Worsening Economic Crisis. The U.S. appetite for imports of Asian information technology (IT) goods has dried up.

- That equates to U.S. "exporting" recession to Asia.
- As unemployment rises in Asia, the worst is yet to come.
- The accelerating Asian recession will fan social unrest, political instability and quite possibly internal military conflict.
- USG must now use all the instruments of power in a seamless web to stem the tide and limit the damage to vital U.S. national interests.

Bounce-back. To better understand this worsening crisis, let's go back to 1999 & 2000. Back then, Asian economies performed remarkably well.

- The Asian economies that were crisis hit in 1997 and 1998 enjoyed an average GDP growth of almost 7%. South Korea averaged 10%.

U.S. Boom. Asia's spectacular rebound owed much to U.S. economic boom.

- Asian exports to U.S. account for 10 - 25% of Asian economies' GDPs.
- About one-half of these have been of IT equipment.
- U.S. corporations rushed out to buy this new IT hardware and Asia's factories were ready to surge to supply it.
- Asia was perfectly positioned to ride the IT tidal wave to recovery.
- Thus, America's economic boom in the late 1990s helped the crippled Asian tigers to recover more quickly than expected from their financial crises.¹
- At first glance, all was well during this bounce-back. After all, Asian exports were booming, which in turn produced large current account surpluses.

Asian Vulnerabilities. But Asia's large trade surpluses—popularly seen as a sign of renewed economic vigor—partly reflected a dangerous failure to generate stronger domestic demand.

- Domestic demand would have been stronger if Asian states had not become complacent and delayed the completion of their promised structural reforms.²

Addicted to Exports. Dithering on reforms has made Asian economies dangerously over dependent upon their exports to the U.S.

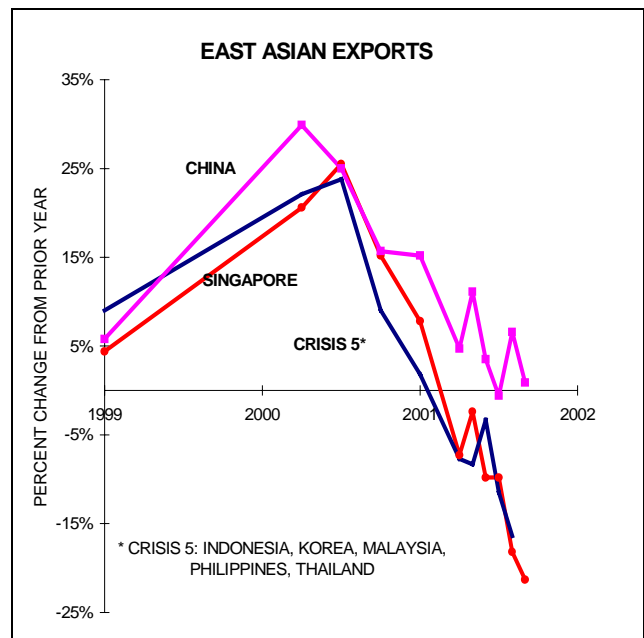
- South Korea's exports of goods and services jumped from 30% of GDP in 1996 to 45% last year;
- Thailand's rose from 39% to 66%.
- Electronic equipment now accounts for over half of total exports by Malaysia, Singapore and the Philippines.
- It makes up as much as 80% of Malaysia's exports to the U.S.

- Two-fifths of Asia's total GDP growth in 2000 came from exports of IT to America, according to Morgan Stanley analysts.
- Asia was thus more exposed to the U.S. and world slump than ever before.

U.S. IT Bust. The U.S. boom of 1999 and 2000 turned into an alarming bust.

- Between January 2000 and July 2001, the price of standard 64-megabyte DRAM chips dropped by 90% from \$8.93 to just \$0.92.
- As a result, U.S. firms cut their IT investment and, hence, their imports from Asia.

Figure 3-A



IT Cutbacks. The impact of the IT bust on East Asia's exports and economic growth has been catastrophic.

- In the countries that had invested most in electronics production (e.g., Malaysia, Singapore, Korea and Taiwan), exports contracted sharply in 2Q01.
- New orders for computers and electronic products fell by a one-third in the year to May 2001, as U.S. capital spending vanished.
- U.S. corporations have an alarming excess of technological capacity worth upwards of \$500B, according to some

Wall Street analysts. This overcapacity caused corporate spending to collapse.

Asian Economic Downturn. All of this is hammering the Asian economies.

- Exports from East Asia, excluding China, have fallen by 10% over the past year, compared with growth of almost 30% in early 2000.
- Real GDP fell in Singapore, Taiwan and Thailand in 1Q01.
- Singapore's economy contracted for the second quarter in succession, pushing the island into recession. And Singapore is the best house in a bad neighborhood.
- Taiwan's exports plunged by 16.6% in June.
- Malaysia's exports fell by 7%.
- South Korea and Hong Kong will be lucky to see GDP growth of 2-3% in 2001; down from rates of 9% and 10% respectively in early 2000.
- China's GDP growth is holding up, but even its export growth has slowed from almost 40% to 4% over the past year.
- Asia is also reeling from sliding currencies, weak stock markets and soaring corporate defaults.

Better Shape than 1997. At first glance, this all bears an eerie resemblance to the nightmare of 1997-98. Bad as things seem, this negative picture does not mean Asia is heading for another Asian financial crisis. In macroeconomic terms these economies are in much better shape than in 1997.³ All the crisis-hit economies of 1997 have:

- Built up robust current-account surpluses instead of deficits,
- Cut short-term foreign debt,
- Amply replenished foreign-exchange reserves.

Good News: Currency Flexibility. Except for China, Hong Kong, and Malaysia,⁴ these crisis-hit Asian economies of 1997 have:

- Abandoned their fixed exchange rate regimes that were at the root of their previous meltdown.⁵

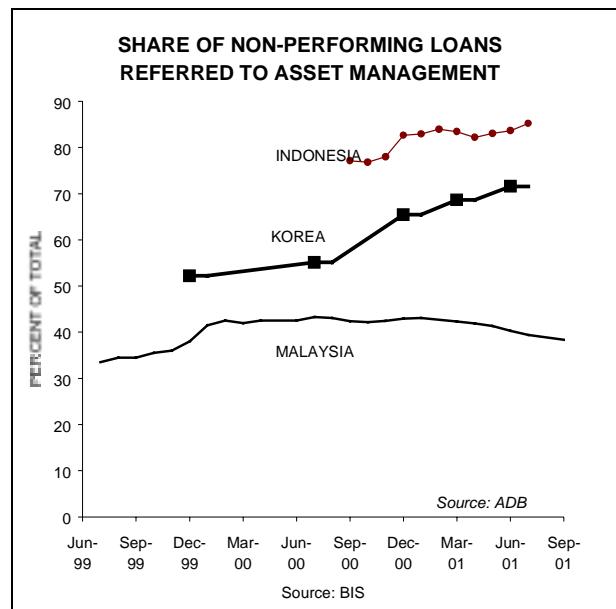
Bad News: Economic Stagnation. All this precludes the sort of overnight currency collapses seen in 1997.

- That said, the risk is that this economic downturn could be even more deep-seated and longer-lasting than the short-lived crunch of 1997 and 1998. Why?
- These economies have no economic driver to replace exports.
- In particular, domestic demand remains weak. Why?

Weak Domestic Demand. Domestic demand has been restrained by balance-sheet weaknesses in banks and companies.

- Firms have been slow to sell off assets and reduce debts.
- Banks have been slow to write off bad loans.
- The rate of referral of non-performing loans to asset management is slow. Malaysia shows absolutely no progress, while South Korea recognizes the problem and is gradually managing its losses.

Figure 3-B



- Governments have failed to deregulate services, which could have created new jobs to offset the collapse in IT exports.
- Fragile banking systems and inadequate corporate restructuring continue to cramp domestic expansion.

- Lower interest rates are less effective in stimulating demand because banks saddled with too many bad loans are reluctant to lend more and debt-laden firms cannot borrow.

Pushing Monetary String. These continuing structural flaws will now make it harder for Asian governments to use monetary policy to cushion their economies against a slump in exports. In particular, fragile financial sectors and companies' weak balance sheets will make monetary policy less effective (like pushing string). As Japan has discovered, lower interest rates can do little to boost domestic demand if:

- Banks, saddled with bad loans, remain reluctant to lend and
- Debt-laden firms remain reluctant to borrow.

Fiscal Constraints. Similarly, the crisis-hit Asian economies have little elbow room to use fiscal expansion to stimulate demand.

- A legacy of the 1997-98 crisis is that many countries already have swollen budget deficits.
- Asian economies, excluding China, ran an average budget deficit last year of almost 4% of GDP.⁶
- In 1997, before the full force of the financial crisis, their budgets were close to balance.
- Thus, Asian governments have less scope to use expansionary fiscal and monetary policies to boost flagging domestic demand.

Lost Opportunity. Asia's emerging economies would be better able to cope with a sharp slowdown in America if they had completed their structural reforms.

- The region's leaders may be wishing they had done more to build the foundations of stronger domestic demand during the years when the American economy was cruising and pulling the rest of the world along in its wake.
- In particular, they may rue the day that they became complacent and failed to undertake a more thorough restructuring

of indebted companies and of the banks that had lent them money.

- The necessary reforms always entailed painful short-term economic, social and political costs.
- But if they were difficult when the global economy was humming, they are very much more difficult now that it is wobbling.
- In short, Asian governments have failed to finish the repair job left from their previous crisis.

Outlook: Delayed Impact

Asian economies are still embattled.

- Asia's export figures lag U.S. electronics orders by around three months.
- In other words, the crushing 21% year-on-year fall in Singapore's electronics exports recorded in June 2001 reflects the 7% drop in U.S. orders in March.

3Q01 Blues. In 3Q01 Asia saw a terrible export shock, with a 30% to 40% year-on-year decline in exports.

- Singapore, where electronic products make up more than 50% of total exports, is already in recession.
- Taiwan, where the proportion is almost as great, looks set to follow.
- At best, U.S. demand for Asian electronics probably will probably not pick up anytime soon.

U.S. Rescue? With few policy options at their disposal, Asian governments are pinning their hopes on a recovery in U.S. corporate profits over the second half of the year and a rebound in investment spending early in 2002.

- The Federal Reserve's interest-rate cuts plus the \$40B tax rebate in 2001 add up to powerful medicine for the U.S. economy.
- The massive U.S. tax cut will also be expansionary.
- Asia's policymakers hope that this U.S. macroeconomic stimulus will trigger a U.S. recovery, which in turn will feed through to a boost in demand for Asian exports. Too bad things are not that simple.

No Bounce-back. Unfortunately, the world has changed since 1999. The U.S. economic

cavalry cannot show up and save the day. Even if the U.S. economy turns around and starts growing in the next few months, it does NOT follow that U.S. businesses will ride to Asia's rescue. Why not?

- When spending does finally recover, IT managers will be under pressure to show tangible return on their investments.
- This means they will focus first on software to reduce costs.
- Replacing the sort of hardware manufactured in Asian factories, which are heavily geared towards personal-computer production, will be a very low priority.
- In short, the PC is old technology and not where intelligent U.S. businessmen want to be focusing their investment energies.

Therefore, the immediate outlook for Asia is grim indeed.

- Countries in the region, Taiwan and Singapore especially, have over-invested in just one sector (electronics manufacturing), leaving them highly vulnerable to shifts in technology.
- And as the steep drop in capital-goods imports to the region over the first half of the year shows, there is little money around just now for re-engineering Asia's overexposed economies.

U.S. Recovery? The good news is that the U.S. and global economy appear to be bottoming out. A U.S. and global recovery is likely to take place later in the second half of 2002.

- The bad news is that weak U.S. corporate earnings and a collapse in U.S. capital spending has delayed the U.S. recovery.
- In this regard, the recent Enron debacle and the shoddy accounting at Arthur Anderson have worsened this situation by undermining confidence in the U.S. business culture.
- Finally, U.S. economic problems have also delayed a strong Asian recovery in 2002. And due to structural problems in Asia, the Asian recovery will likely be weaker than would otherwise be the case.

Conclusions

The economic bounce-back in Asia is over. Economic growth is slowing down. Asian economies are increasingly vulnerable to a number of shocks. These shocks include the slowdown in the U.S. economy, the softening of Asia's information technology market, and until recently, the spike up in the price of oil.

Key economic reforms are slowing or halting. Reforms are sluggish in such areas as restructuring heavily indebted companies, restoring badly damaged banking systems, improving corporate governance, and curbing corruption. Borrowers have taken advantage of inadequate procedures for bankruptcy and liquidation to withhold repayments in the hope of getting better deals from bankers.

In this regard, the Asian financial crisis is not over. Asia now faces a legacy of heavy debt, skittish investors and household insecurity. To reduce their vulnerability to financial turbulence, Asian economies must clean up banks, restructure domestic corporate debt and implement good bankruptcy laws.

Endnotes

- 1 The super-competitive currencies of crisis-hit Asian states after devaluation in 1997 and heavy deficit spending also drove the strong recoveries.
- 2 How incomplete structural reforms cramp domestic demand will be discussed later in this paper.
- 3 That said, in one respect, matters actually look much bleaker than they did in 1997. Then most of the region enjoyed relative political stability. Now, from Indonesia to the Philippines, it looks more explosive, with FDI also leaving SE Asia.
- 4 China, Hong Kong and Malaysia are still pegged (de facto) to the U.S. dollar. Of these, Malaysia gives the most immediate cause for a devaluation concern, though China has said that the weak yen threatens its own currency and is hurting Chinese exports.
- 5 For an analysis of the dangers of pressure cooker, rigid exchange rate regimes in Europe, Latin America and Asia in the 1990s, see Leif Rosenberger, "Global Financial Turmoil: Diagnosis and Prescription for President Bush," in the forthcoming book entitled *The Search for United States Security: A Forward Strategy for the 21st Century*, to be published by the Army War College Strategic Studies Institute.
- 6 As part of the Maastricht rules of thumb for financial stability, budget deficits should remain under 3% of GDP.